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TAGS: ETRD ECON EIND EINV ELAB PREL CH
SUBJECT: BAO STEEL GLOOMY ON QUICK ECONOMIC RECOVERY

SHANGHAI 00000070 001.2 OF 003

Subject: Bao Steel Gloomy on Quick Economic Recovery

¶1. (SBU) Summary: China's largest steel producer, Bao Steel, is pessimistic about China's economic prospects through 2009. In a February 3 meeting with Bao Steel, Vice President Dai Zhihao said that demand in China's steel market remains lackluster with no sign of recovery. Although excess stock is finally drying up, prices remain close to fifty percent off their July 2008 peak. Recent incremental price increases in steel during the past four weeks are not a sign of increased demand, but rather a result of traders' speculation. Bao Steel will benefit little from China's economic stimulus package, since it mainly specializes in flat products used in cars, appliances and shipbuilding - not long products used in large infrastructure projects. Dai said he was concerned about signs of protectionism creeping into the world trading system and voiced strong opposition to the proposed Buy American clause in the U.S. stimulus package. End summary.

China's Steel Prices Reach "Ridiculous" Levels
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¶2. (SBU) As a bellwether for the country's heavy industry, China's steel production continues to contract at a rapid clip, said Dai. As soon as the 2008 Olympics opened, the demand for steel, as well as the price, began to sink. Beginning in October, prices went into a complete nosedive and have now ended up at 50 percent of what they were at their July 2008 peak. Dai attributed this rapid price decline to both external and internal factors. The global financial crisis and its subsequent spill-over into the real economy forced many Chinese firms that manufacture for export to decrease or stop production and reduce their inventories. As a result, demand for steel slumped. Internally, Chinese steel producers were initially overly optimistic on China's ability to weather the economic storm and kept pumping out steel at normal levels. Dai said that Chinese steel producers believed any effect from the global economic downturn on China would be shallow and short-lived. When it finally sank in that the global economic downturn would have a long-lasting and deep effect on China's economy and stocks had been built up too high, steel prices dropped to "ridiculous" levels, noted Dai. As a result of the steep price decline, steel distributors have become reluctant to buy more steel because they built up inventory when prices were high and

are not in a position to take on additional risk.

Don't Misconstrue Rise in Steel Prices

¶3. (SBU) Dai warned not to interpret steel price rises in the first weeks of 2009 as a sign of economic recovery. There is no increase in real demand to support this rise in prices, said Dai. He explained that as demand waned, prices fell faster than demand. Steel producers' margins sank to zero. Trading companies recognized that steel was undervalued, and as credit has started to trickle out from banks in recent weeks, traders seized the opportunity to buy steel. The other contributing factor, said Dai, is the steel industry's 25 percent supply cut. Bao Steel has followed suit, trimming its output by 25 percent. On a positive note, Dai said that China's overstock of steel is close to an end. (Note: According to China Steel Association figures, steel prices have rebounded somewhat from their low point. The China Weekly Steel Products Price and Price Index (combination of all steel prices) has inched up six percent from the third week of December to the last week of January. End note.)

No Collaboration Among Steel Producers

¶4. (SBU) Dai explained another reason for the rapid price drop and overstock of steel - China's steel producers are unwilling to collaborate on supply cuts. "If everyone agrees to shut down the same amount of capacity, it would benefit all the players in the sector." However, unlike Japan, it is impossible for all the players to settle on a reduction, said Dai. If Bao Steel cuts capacity, other companies will not follow suit but reap the benefits of a steel price rebound.

Government Stimulus of Little Consequence to Bao

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¶5. (SBU) Dai was cautious on any immediate effect from government's stimulus package, saying any effect would not be noticeable until the end of the first quarter. He believed if external financial conditions fail to improve, steel prices may drop again. "The worst might be yet to come," he said. The Government's stimulus package will also have little direct impact on the company. Bao produces relatively fewer long products, which are used in reinforced concrete, buildings and bridges. Demand for these products has seen some rebound in demand due to government investment in infrastructure. However, the company produces a relatively larger amount of flat products, which are used in appliances, ships and autos. Many of these products are produced for export and still face dropping demand. Regarding Bao Steel's primary client industries, he explained electronic appliance exports are falling rapidly, client shipbuilders around the globe have had no new orders in the past two months, and the auto industry in China may see more declines if China's auto bailout measures fail to have any real effect. Moreover, the main winner in the stimulus is railway steel, which Bao Steel does not produce. Maanshan Steel, Angang Steel, and ShouGang Steel are the main railway steel suppliers in China.

Industry Consolidation - Let the Cards Fall Where They May
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¶6. (SBU) The Chinese Government is still encouraging consolidation in the steel industry - but it now has to walk a fine line, said Dai. If it pushes too hard on consolidation and steel mills are shut down, unemployment will increase, particularly in areas that may be heavily dependent on the industry. However, because the steel industry has been so profitable over the past 10 years, a plethora of small steel mills have opened their doors in China, which not only increased capacity but also created fierce competition. The Chinese Government pushed the industry, especially the smaller players,

to consolidate for years. Dai said the current financial crisis provides the perfect opportunity to "crowd out" the smaller, inefficient players.

Cash is King

¶7. (SBU) According to Dai, Bao Steel has a large amount of cash on hand and is prepared to acquire other steel companies at a "reasonable" price. The company has made numerous attempts in the past and sometimes failed. Now the time is ripe for buyouts, said Dai. For example, Bao Steel intended to acquire a Ningbo steel mill last year, but the plan was scrapped when the Ningbo company demanded an unreasonably high price. Since the economic downturn, the same Ningbo firm returned to the negotiating table - this time offering a much lower price for a buy out. Dai said Bao Steel is patently opposed to any Government measures that would bail out the industry. It is time for the smaller, inefficient companies to exit, said Dai.

Skeptical on Overcapacity

¶8. (SBU) Dai was skeptical that China's overcapacity problem in the steel industry would be resolved in the near future. Too many local governments were propping up steel mills to ensure local economic growth. It is impossible to fully put into production China's 600 million ton annual capacity, said Dai. He noted that the steel industry was not the only one in China to face this overcapacity dilemma - shipbuilding and the auto industry face similar challenges.

Views on China's Economy

¶9. (SBU) Dai was pessimistic on a quick V-shaped recovery for the Chinese economy. Since people in China have not experienced a severe economic downturn in more than 30 years, he said they tend to be overly confident in China's economic capacity and overly optimistic that the country can quickly bounce back. Dai felt the slowdown could last longer than people expected, explaining that over the past 30 years China built much of its

economy on heavy industry, and it is now heavy industry that is now taking a large hit. He also expressed doubt that GDP growth could meet the Central Government's eight percent target for ¶2009. Based on his long experience in the steel industry, he added that he had never seen it so bad. However, he praised the Central Government for reacting quickly to the downturn by releasing a substantial stimulus package. Without the stimulus package, the Chinese economy this year would be much worse, said Dai.

Exporting the Misery

¶10. (SBU) As China's steel industry has stumbled, the pain has spread to many other countries, Dai explained. For example, Bao Steel imported approximately 75 percent of its iron ore - about one third from Brazil and two thirds from Australia. Dai said Bao Steel has substantially decreased orders from both countries. He added that Bao Steel contemplated major investments in both countries earlier in the year and is very lucky that neither of the deals was concluded before the economic downturn - otherwise the company would now be strapped for cash. Decreasing orders from China has hit mining companies hard, forcing them to make substantial cuts in output, close to six percent globally. Bao Steel buys most of its iron ore from three large mining companies: BHP Billiton, Rio Tinto and Vale. Of the three, Rio Tinto is in the worst shape because of enormous debts the company racked up prior to the credit crunch. Bao Steel has a long-term contract for iron ore with BHP Billiton, which is relatively better off.

Dismay over Signs of U.S. Protectionism

¶11. (SBU) Dai angrily dismissed "Buy American" provisions in the U.S. economic stimulus legislation as clearly protectionist. Although Bao Steel does not export steel to the United States, Dai believed that other Chinese steel producers would likely push for "similar protectionist measures" should the provisions be approved. Dai noted his concern that President Obama might give in to the U.S. steel industry's union. "You save one industry and destroy many other industries", noted Dai. "Steel is the food for all industries, including manufacturing, machinery and automobiles." Dai further explained that U.S. steel prices are already among the highest in the world, and if the U.S. Government "persists with protecting the domestic steel industry," its downstream consumers in the United States will suffer.
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